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C O N F I D E N T I A L SECTION 01 OF 03 ISLAMABAD 000288

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E.O. 12958: DECL: 01/15/2018
TAGS: ECON EFIN EINV PGOV PREL PK
SUBJECT: STATE BANK OF PAKISTAN: ECONOMIC OUTLOOK LESS THAN ROSY

REF: 07 State 5328

Classified by: CDA Peter Bodde for reasons 1.4 (b) and (d)

Summary

¶1. (C) Summary: In its January 5, 2008 first quarterly report, the State Bank of Pakistan (SBP) reduced its June 30, 2007 - July 1, 2008 (FY08) growth rate target range to 6.6-7.0 percent from 7.0-7.4 percent due to deterioration in the investment climate resulting from increased domestic instability, decreased global liquidity, and below-target cotton and rice crops. The local IMF Resident Representative, however, projected that growth would be at just six percent. The World Bank Islamabad economists Hanid Muktar and Kaspar Richter believe that growth will be about five percent, but highlighted that the real story is the deterioration in Pakistan's current account.

¶2. (C) Summary continued: The outlook for the services sector (accounting for over half GDP) remains positive, backed by acceleration in retail and wholesale trade, and better performance by the financial sector. Although the large scale manufacturing sector growth rate has slowed down to 6.9 percent in the first quarter, it appears strong at 8.0 percent excluding electronics. SBP expects a revival in the manufacturing sector driven by infrastructure industries, which grew 8.3 percent annually in the first quarter of FY08 versus 3.7 percent in the preceding year. The report, which covers data through November 30, 2007, also comments quite frankly for the first time that domestic and international developments put continued economic growth at risk. End summary.

Good economic performance despite increasing uncertainties

¶3. (C) According to the SBP report first quarterly report released January 4, Pakistan's economy performed "reasonably well" in the initial months of FY2008, despite increased domestic and international economic uncertainties. However, risks to the economy are increasing because the "global and domestic economic environment is not as benign as in the past few years." The SBP also forecasts that the FY08 growth rate is likely to be below the 7.2 percent annual target. The GOP, however, still has not revised its economic targets. The Economic Adviser at the Finance Ministry, Dr. Ashfaque Hasan Khan, agrees with the SBP that the GDP growth rate is likely to fall short of the target and remain between 6.5 percent -7 percent. In addition to recent violence and market closures, the below-target cotton and rice crops because of pests and untimely rains contribute to lower GDP growth estimates. Cotton production is estimated at 12.8 million bales, compared to the 14.1 million bale target and last year's 13 million bale harvest. The IMF resident representative, Henri Lorie, told Econoffs that the GDP growth is likely to be around

6 percent in the current fiscal year because of excessive government borrowing from the Central Bank, increased commodity prices, and decreased tax revenue.

¶4. (C) The growth rate of the large-scale manufacturing sector slowed down in the first quarter of FY08, although disaggregated data reveals a mixed picture. Many industries including fertilizer, pharmaceuticals, petroleum refining and some metal and engineering goods, rebounded strongly after disappointing performances in the previous year. However, cotton yarn and cloth (weak export demand and a poor cotton crop), automobiles (the government relaxed imports), and edible oil and vegetable ghee (demand slackened in the face of nearly doubled prices) performed poorly. Khan, however, was upbeat about the manufacturing sector's performance, given the more recent data. The large scale manufacturing sector recorded a growth rate of 7.7 percent in July-Oct 2007, while in the month of October it grew 9.8 percent. Sugar production, which represents 4.15 percent of the overall manufacturing sector, grew 122 percent in December and will likely bump up overall manufacturing production. The services sector is likely to maintain its growth momentum, and is estimated to grow at the rate of 8 percent in the current financial year.

Continued growth in net credit and strong aggregate demand

¶5. (SBU) Growth in net credit to the private sector appears to be stabilizing at around 15 percent annually, indicating that the domestic economic growth is continuing at the same pace. Companies, which have found it cheaper to borrow overseas, may revert to the domestic markets given the widening of Eurobond and other international financing spreads, possibly further increasing credit growth. The State Bank of Pakistan is following a tight monetary policy to dampen inflation. Increased GOP borrowing, however, is expanding the money supply, eroding the effectiveness of the SBP's

policy and pushing up the inflation rate.

¶6. (SBU) Strength in aggregate demand coupled with the impact of rising global commodity prices is reflected in the persistence of high domestic inflation. Consumer price index inflation rose to 9.3 percent annually in October 2007 primarily driven by a 14.7 percent annual jump in food inflation. Since May 2007 core inflation (non-food non-energy) has also been increasing. Excessive government borrowing from the State Bank has enhanced monetary expansion by six percent, and is also increasing inflationary pressures. Excessive government spending and significant increases in international commodity prices are also fueling inflation. As of January 5, the GOP has borrowed a record $3.93 billion from the banking system since the beginning of the current fiscal year July 1, as compared to only $1.02 billion during the same period last year. These inflationary pressures will rise further, once the government makes the difficult political decision to pass along the increase in international oil prices. The GOP has already overshot its subsidy budget by over 100 percent this fiscal year. (reftel)

¶7. (C) In recent public statements, the caretaker Finance Minister Salman Shah has highlighted the need to increase oil, gas and power prices to reduce current expenditures. Shah warned that the fiscal deficit target will not be met if the GOP continues these subsidies and does not begin to pass on higher energy costs to consumers. As the inflation rate continues to increase, it will be more difficult to pass along these increases. Khan attributed the recent wheat crises in the country and high food inflation to international food shortages and wheat smuggling from Pakistan to India, Afghanistan and Iran due to lower prices in Pakistan. Khan told Econoffs that Pakistan accounts for 600,000 tons for Afghanistan's wheat requirements in its target calculations, but that this year, Afghanistan has chosen to import the majority of its wheat from Pakistan because of lower prices than other suppliers. Pakistan usually exports 600,000 tons of wheat to Afghanistan, and Afghanistan imports the remaining approximately 1 million tons from Central Asian. Khan also commented that Iran is stockpiling wheat in the event of additional sanctions.

Fiscal deficit expands; tax revenue target unlikely to be met

¶8. (C) The SBP highlighted that all key fiscal performance indicators have deteriorated significantly in the first quarter of FY2008. Development expenditure, which principally includes infrastructure projects, rose 89.5 percent in 1Q FY08, is one of the major contributors to higher fiscal deficit. Most observers consider that this dramatic increase is tied to the upcoming elections. The government's budgetary borrowings from the banking system from July 1 through December 1 rose by Rs. 191.3 billion ($3.08 billion) compared to Rs. 97.6 billion ($1.57 billion) in the same period last year. The difference between total revenue and current expenditures moved from a surplus in the first quarter of FY2007 to a deficit in the first quarter of FY2008, despite an impressive growth of 22.3 percent in total revenues during this period.

¶9. (C) IMF ResRep Henri Lorie told Econoffs that recent data paints an even less rosy picture, with tax revenue increasing only 4 percent versus the 22 percent target. Khan acknowledged that the GOP will certainly miss its fiscal deficit target of four percent because of tax collection shortfalls, the U.S. decision to shift the $200 million in budgetary support to projects, and delays in Coalition Support Fund (CSF) reimbursements, according to Khan. He further elaborated that the delay in CSF reimbursements is causing the government to borrow money from the State Bank of Pakistan. In response to EconCounselor's question, Khan did acknowledge the contribution of increased fuel subsidies to the growing fiscal deficit. Most analysts expected that the fiscal deficit will come in at 4.5-4.9 percent this fiscal year.

Exports grew at 11.3 percent annual rate, but the current account deficit a concern

¶10. (C) Exports grew at an 11.3 percent annual rate from July-October 2007 due to a 23.1 percent increase in non-textile exports. Khan said that the GOP is likely to meet its 10 percent growth rate target in exports, despite an expected dip in exports in December due to delays caused by the post-Bhutto assassination violence. Despite only a 6.6 percent increase in textile exports, Khan was confident that Pakistan could meet its 10 percent target because of the 10.5 percent growth in the overall export growth. Non-textile exports have increased significantly.

¶11. (C) Managing the growing current account deficit will continue

to be a challenge in FY08. Increasing international oil prices are mainly responsible for widening current account deficit. Higher oil prices have increased Pakistan's oil import bill to $7.3 billion in FY 07, according to Khan. Oil imports represent 27.5 percent of Pakistan's total import bill.

¶12. (C) The trade deficit remains high despite the increase in exports and decrease in non-oil imports. The impact of 22 percent growth in remittances was diluted by continued service and income account deficits. In addition, profit and dividend outflows increased 14.3 percent over the previous year to $398 million. The SBP forecasts a 5.2 percent of GDP annual account deficit. During July-October 2007, Pakistan recorded a surplus of US$ 3.2 billion in the capital and financial accounts, compared to a US$ 2.8 billion surplus last year. The increased surplus was mainly due to increased debt because of external borrowing. Equity flows were negatively affected by portfolio investment outflows and postponement of new privatization programs.

¶13. (C) World Bank Senior Economists Hanid Muktar and Kaspar Richter highlighted their concern with Pakistan's current account deficit and decreased foreign inflows. Muktar commented that "the government needs to get over its obsession with growth rates" and focus on reducing the current account deficit. Both agreed that the GOP needs to cut back on energy subsidies, particularly since Pakistan has not yet felt the true cost of oil imports due to long-term contracts at below spot market prices and export growth is not sufficient to compensate for increased prices of imported commodities. They hoped the foreign exchange rate flexibility would continue. Muktar was also concerned that tight SBP monetary policy, excessive government borrowing, and increased Pakistan Eurobond spreads would create a credit crunch and hurt private sector growth.

¶14. (C) Mr. Khan told Econoffs that he expects FDI inflows to continue despite present uncertainties. FDI was up by 15.6 percent in the first five months of the current financial year, principally due to a few large transactions including a $5 billion UAE refinery project. In January 2008 Barclays Bank came to Pakistan. Tamarserk, the Singapore's investment arm, has taken a long term view of investment prospects in Pakistan. NIB bank taken over by Tamaserk and later merged with Picic is now the fourth largest bank in Pakistan.

¶15. (C) Merrill Lynch believes that foreign flows into Pakistan are structural, not cyclical. Though short-term jitters cannot be ruled out, it expects sustained FDI inflows attracted by the market potential from Pakistan's young population (average age: 20) and strong economy. Portfolio investment outflows have, however, been a problem for Pakistan during recent months. Citibank sources, however, see grim prospects for foreign investment in Pakistan due to law and order problems and political turbulence in the run up to elections.

Comment

¶16. (C) The State Bank report was drafted prior to the December 27 Bhutto assassination using data through the end of November. Analysts expect that the economic situation will look even worse once the December numbers are released, due to the nationwide three day closure following the Bhutto assassination. We agree with the IBRD economists that the current account and fiscal deficits are more worrisome than knocking off a point or two of economic growth. As an open economy, Pakistan is a price taker for international commodities. Until the GOP can pass along increased oil costs to consumers and figure out a way to rationalize power tariffs, it will continue to absorb these costs and run up a larger current account deficit. Despite anecdotal evidence that Gulf investors continue to be interested in coming into Pakistan, we have not heard anything in the way of new foreign direct investments. We are also watching the increased GOP borrowing and its effect on private sector growth carefully. Most businessmen that we have talked to in the past few weeks continue to put any expansion plans on hold until after the elections scheduled for February 18. The new government will face some difficult decisions in a challenging international environment to keep Pakistan on its solid economic trajectory. End comment.

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